Current Economic Perspectives
Martin Fleming to: Martin Fleming 12/02/2016 02:22 PM

- Financial markets are eagerly awaiting the next act in the global political drama as Italians will vote Sunday on a series of reforms. Prime Minister Matteo Renzi's offer to resign should the referendum fail has cast the outcome in the same terms as the leadership changes in the US and UK. Concerns among Italians about failing banks and continuing immigration raises the probability of a third national political shock.
- Western political leadership is changing before our eyes. Matteo Renzi is the new David Cameron, flirting with referendum disaster. While Angela Merkel is the Hillary Clinton of Germany. She used to wear an aura of inevitability but now has become a polarizing figure. With only a 4% approval rating, French President François Hollande concedes the obvious and will not seek re-election.
- The Organization of the Petroleum Exporting Countries (OPEC) announced it would cut production by 1.2M barrels per day (bpd) from 33.6M. OPEC expects producers from outside the group, including Russia, to join with an additional 600,000 bpd reduction for a total 1% global production cut. Oil prices rose 14% over the week.
- *Current Economic Perspectives* is available in the Chief Analytics Officer Connections community. Here's the link.

As of Noon	***Today Dec. 2, 2016***	***3-Months Ago (Sept)***	***Year Ago***	***YoY Change***
Global Dow Index	2,463.2	2,463.6	2,389.5	3.1%
Brent Crude Oil	$54.09	$45.96	$41.92	12.17/bbl
Dollar/Euro	1.067	1.116	1.057	0.9% $ appr
Yen/Dollar	113.85	104.18	123.52	7.8% $ depr
China RMB/$	6.880	6.679	6.388	7.7% $ appr
10Y T Bond	2.38%	1.60%	2.18%	20 bps

Has the Global Economy Reached a Secular Turning Point?

Over the past two years, we have frequently written that the global economy is "stuck in a low-level equilibrium." Some have referred to secular stagnation – an extended period of well below average growth. With the strong rally in US equity markets, dollar appreciation, and the run up in interest rates, the question is: have financial markets made a secular turn and, if so, will the global economy follow suit?

The short answer, of course, is that it's too early to know. However, when the US Federal Reserve ended its Quantitative Easing initiative in 4Q2014, the S&P 500 stock index moved sideways, with some volatility, until November 8th. The absence of Fed provided financial market liquidity removed upward price pressure just as corporate profitability was eroding, oil prices were beginning a lengthy fall off, and the dollar began a substantial appreciation.

Shift in Fiscal Policy

With the dramatic change in the policy and political landscape in the US and EU, it is likely that fiscal policy will pick up the stimulus burden from the major global central banks.

As is well known, by now, the incoming Trump Administration will very likely propose a series of corporate and personal tax cuts along with a major infrastructure rebuilding program. As a result, the US growth forecast for 2017 and 2018 has been revised up. GDP growth in 2018 is expected to be 3.0%, a 1.4 percentage point improvement.

Stronger growth will bring more robust price and wage inflation. In the US, consumer price inflation will reach 3.0% by 2020 and wage inflation will reach 4.0%. The Federal Funds rate will be 4.0% by the end of 2020 and the 10-year Treasury rate will climb to 5.0%.

In addition, with growth having averaged only 0.6% since 2012, the euro zone nations are beginning to think differently about the continued embrace of austerity. Despite recent 1.6% y/y 3Q GDP growth, with the unemployment rate remaining stuck at 10.5%, euro zone political leaders are increasingly focused on the use of discretionary fiscal policy to boost growth.

In the clearest sign of the shift, heavily indebted Italy is increasingly inclined to challenge German led fiscal austerity. Spain and Portugal experienced the worst of the crisis and both have been eager for relief from the strictures of the euro zone imposed spending caps. Both nations have budget deficits well above the 3% GDP limit. Yet in July, after the June 23rd British referendum to leave the EU, euro zone leaders chose not to fine either nation, instead giving them additional time to bring their deficits under the cap.

Drivers of Robust Growth

As a general statement, to revive robust global growth, there are four forces that need to act simultaneously. Two are already creating pressure for renewal and, if political leaders act, two more might be increased sources of pressure.

First, the average age of the fixed capital infrastructure is now 22 years, four years older than its most recent youngest point in the late 1960s and about the same age as in the late 1930s and early 1940s. The antiquated private and public infrastructure is already creating pressure for renewal.

Second, there is a widening gap between the technological possibilities with a new generation of capital infrastructure and the existing aged infrastructure. The widening gap creates increased pressure on business leaders to leap-frog technology generations. A simple look at research and development spending shows the continued growth. With the advent of cognitive capabilities, R&D spending continues to increase in importance, even as private spending grows more rapidly than public spending.

Third, the utilization of existing capacity is increasing, but remains below its point of maximum pressure. From a mid-2009 low of 67%, US capacity utilization has reached 79% in late 2014, but has now fallen back to 75%. A tax and infrastructure program has the potential to increase the demand for unused capacity.

Fourth, a marked increase in wages relative to the cost of capital is necessary to shift the capital-labor ratio. Capital costs are currently low. Prices and wages have been increasing at about the same rate for the past five years. The shift in relative prices and factor costs have begun to makes the economics of fixed capital spending – the business case – more favorable. Less austerity and more aggressive fiscal policy, over time, will serve to increase wage and price inflation.

Finding a New Growth Formula

As with any view of the future, there are uncertainties. The very substantial policy changes under consideration will not find support in all corners of the US and EU political leadership. Ironically, it is largely center-right governments that are proposing reduced austerity. It's certainly possible that agreement will not be found.

Second, even with the implementation of a fundamentally new fiscal policy regime, it is not clear more robust growth is sustainable. After an initial 12 – 18 month period of policy induced growth, the aggregate demand growth must be matched by aggregate supply growth. Higher wages and prices will help incent supply expansion.

However, with labor force growth only very slightly above zero, supply expansion will be difficult. Between 2018 and 2021, expect labor supply growth in the euro zone to average 0.2% per year, in the US annual growth will be 0.3%, in Japan labor supply growth will be 0.1%, and in the UK growth will be 0.4%.

To achieve a sustainable growth rate of 2.0% to 2.5% across Europe, Japan and the US, productivity growth would have to increase substantially. The current 2018 - 2021 forecast is for annual productivity growth of 1.2% across the economies. The potential growth rate is the sum of labor force and productivity growth which across Europe, Japan and the US over the 2018 – 2021 period is expected to be 1.5%.

The challenge facing business and political leaders in the period ahead is answer some difficult questions. What will be the powerful new engines of economic growth? Will the old engines of growth sputter and die? Is it possible to increase productivity, employment and wage growth simultaneously?

Global Data Weekly

US: Payroll employment rose a steady 178,000 jobs in October nearly identical to the 180,000 per month all during 2016.

The labor force participation rate fell again, since peaking at 62.9% in September it has fallen the past two months to 62.7%. The difference meant among 700,000 workers some stopped looking for work while others never started. In concert, the number of unemployed fell by 539,000 the largest two-month decline in over two years. Both moves led to the unemployment rate tumbling from 5.0% to 4.6%.

Wages fell 0.1% m/m in October to give back some of the 0.4% m/m gain in September. Weekly average paychecks rose 2.2% y/y, stepping down from 2.5% y/y and 2.4% y/y in the prior two months. The problem in take home pay hasn't been wage increases, but the decrease in hours needed on the job site. When earnings growth peaked at 2.8% y/y in early 2015, hours worked was one third of the contribution. Not coincidentally, capacity utilization during that peak period was 78.9% but has since slumped to 75.3%. The reduced activity translated into fewer hours worked.

Real GDP growth was revised up from an annual rate of 2.9% to 3.2% in 3Q, the fastest pace in two years. The stronger growth was organically driven due to consumer spending up 2.8% and a 10.1% increase in exports.

Not all the news was encouraging. The growth in nonresidential fixed investment was revised down from 1.2% to 0.1%. Worse, business investment in equipment declined for a recession-like fourth consecutive quarter and six of the prior eight. Dismal October orders and shipments suggest the slump will extend into a fifth quarter.

The better performance of consumer spending and income, including profits, bodes well for final demand in subsequent quarters. However, expect that after adding to overall GDP growth in 3Q, both inventories and net exports will, once again, subtract from growth in 4Q2016 and 1Q2017. The 3Q strength in inventory accumulation and exports was a result of a statistical quirk in data from the agricultural sector.

Real GDP growth in 4Q is expected to be 2.1%, making the 2016 annual growth rate 1.6%. Growth in 1Q2017 will disappoint at 1.3%.

Consumer spending advanced 0.1% m/m in October. The gains point to 4Q consumer spending growth holding in the 2.0% to 2.5% range. The October performance suggests a strong 4Q for consumer spending.

This year’s holiday sales are likely to outperform 2015. November consumer confidence surged, adding an extra boost to holiday cheer. The good news stems from wage gains which were respectable for two straight months. Wage momentum is a major factor in holiday spending. In addition, the recent performance of the equity markets is good news for luxury retail in November and December.

Brazil: Activity in 1H2016 seemed to show the “all-clear” signal for renewed growth was about ready to sound. However, 3Q showed 3Q2016 GDP contracted 3.3% q/q as the recession intensified. The data also indicate that the Brazilian economy continues to lose jobs, albeit at less severe rates, with the central bank's index of employment is still trending down.

Clearly the consumer is not in a position to help the economy. Employment - both formal and informal - continues to decline and wages are not growing as much as inflation so purchasing power is shrinking. Real wages dropped 1.6% y/y in October.

Furthermore, the labor market usually lags the recovery of the economy so this will not improve for quite some time. In addition, credit for consumption will not help. Households are still highly indebted and need to deleverage. Interest rates are also still very high, banks still have tighter standards, and are reluctant to lend without robust collateral.

The conditions for a rebound are not yet clear as the government must prove it is able to fix economic policy to create an environment of economic stability where business leaders can be certain the government will not crowd out private investment.

Germany: Weak 0.8% q/q annualized 3Q GDP hides a solid recovery in domestic demand propelled by consumer spending and construction, implying growth should return to a robust annualized pace of around 2%. The weak 3Q growth was weaker than the previous quarter’s pace of 1.7% and even 2.9% in 1Q2016.

Domestic demand rebounded from slight slippage 2Q to growth of 2.0% q/q. By contrast, net exports swung from a positive contribution of 0.5 percentage point to overall GDP growth to a negative one of 0.3 percentage point. The negative impact was almost exclusively due to deteriorating exports.

Private consumption growth strengthened after weakness in 2Q and public consumption growth remained very robust at around 3.9% q/q. Investment stagnated, but this represented improvement following its 2Q dip. Equipment spending slipped modestly, while construction investment returned to positive territory. Changes in inventories marginally supported GDP growth.

Italy: Real GDP for 1H2016 was revised slightly higher and for 3Q2016 revised slightly lower. The result was a small gain in the annual rate 1.0% y/y up from the 0.9% y/y in the first estimation.

Importantly, positive real income effects helped consumer spending to rise for a twelfth straight quarter in 3Q, but at a slower pace, suggesting households were more cautious.

Overall business investment spending grew by a stronger than expected 3.2% q/q annualized after stagnating in the previous quarter. Firmer investment was a result of rising spending on machinery and equipment, increasing by a sharper than expected 12.4% q/q. But, the industrial investment has remained moribund over the longer period. Spending on machinery, equipment and weapon systems was €90B in 2015, still significantly below the recent 2008 high of €119B.

UK: GDP growth in 3Q held up well at 2.0% q/q. Although down from 2.7% q/q growth in 2Q, the growth is still a highly resilient, solid performance in the aftermath of June's vote to leave the EU. Indeed, it was better than 1Q growth of 1.7% q/q.

Growth benefited from ongoing robust consumer spending, which increased 2.6% q/q and 2.6% y/y. The 3Q strength followed growth of 3.5% q/q in 2Q and 2.6% q/q in 1Q. Economic fundamentals were still favorable for consumers in 3Q, with employment reaching a record high and earnings growth running clearly above inflation. Compensation of employees rose 5.2% q/q and 3.8% y/y in 3Q. In addition, the weakened pound clearly encouraged spending by overseas visitors to the UK, as well as supporting foreign orders for UK goods and services.

Business investment spending expanded 3.7% q/q in 3Q, which was encouraging given the concerns that business investment spending would immediately slump as a result of heightened uncertainty after June's vote. However, it is likely that much of this investment had been planned before the UK voted to leave the European Union.

Business investment spending had previously grown 4.0% q/q in 2Q after contracting 4.3% q/q in 1Q. Consequently, business investment spending was still down 1.6% y/y in 3Q. Total investment spending in 3Q also benefited from gains in general government investment, which was up 8.0% q/q, and private-sector investment in dwellings, which was up 2.8% q/q.

Japan: The index of industrial production rose 0.1% in October. The gain was the third consecutive monthly increase. With a 2.2% October increase in producers' shipments following a 1.8% m/m September increase, production will need to rise further to match the shipments.

As producers' shipments outpaced production, inventory declined 2.1% m/m, which led the inventory index to reach its lowest level since April 2014.